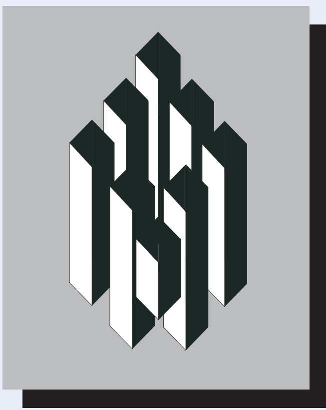

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Federal Transfers: Principles, Practice, and Prospects

Michael Smart

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Inside...
The federal government is unable to commit to a stable set of fiscal arrangements for the long term, destabilizing public finances and undermining accountability and incentives for all levels of government. It is time, therefore, for Canadians to consider major reforms to fiscal arrangements.

The Study in Brief

Recent negotiations between Ottawa and the provinces have led to a series of large-scale reforms to federal transfers for health and equalization, and to a rise in extraordinary bilateral fiscal arrangements. This chequebook federalism has destabilized public finances in Canada and has the potential to undermine accountability and incentives for both orders of government.

Apparently the federal government is unable to commit to a stable set of fiscal arrangements for the long term. It is time, therefore, for Canadians to consider a major reform to fiscal arrangements, in which federal cash grants are eliminated and enhanced tax room and taxing powers are transferred to the provinces.

The Author of This Working Paper

Michael Smart is Associate Professor of Economics at the University of Toronto and Research Fellow at the C.D. Howe Institute.

The past two years have been a tumultuous period in the normally sleepy field of federal fiscal arrangements. The federal government and the provinces have reached agreement over major increases in and changes to federal transfers for health, social services, and postsecondary education, and Ottawa has initiated a process that will lead to the most fundamental reforms to the equalization program in more than a generation (Smart 2005). At the same time, the federal government has pursued a number of unilateral and bilateral initiatives, such as the introduction of direct federal-municipal transfers and the negotiation of a number of extraordinary bilateral agreements with provinces over transfers. Such changes are likely to continue as the premiers call for new federal transfer programs, as provincial voters look more closely at how they fare in the balance sheet of Canadian federalism, and as some commentators make the case for more fundamental reforms to the system.

Whatever the reasons for the advent of "chequebook federalism" in Canada, it is important to understand the principles that should govern federal fiscal arrangements and the problems that can arise when those principles are set aside. In this note, I put forward the case that transfers must be designed to fill the inevitable gaps between the appropriate levels of expenditure and revenue at each level of government — but in a way that preserves incentives for provincial governments to act in the interests of all Canadians. In contrast, I argue, the complex and shifting nature of federal transfers today tends to undermine government incentives to the detriment of all.

I will begin by laying out standard principles of public finance that should govern the allocation of spending responsibilities and tax powers between federal and provincial governments, and the implications for the transfers required to support these arrangements. I then trace the evolution of fiscal arrangements in the 10 years since the federal government attempted to consolidate and stabilize major transfers in the Canada Health and Social Transfer (CHST). I show that actual experience has been quite different than what was anticipated in that reform, and that actual transfers under the CHST have consistently exceeded the amounts forecast in the federal government's own medium-term plans. Next, I discuss the consequences of this commitment failure for fiscal policy in Canada. Finally, I make the case for a major reform that would eliminate federal cash transfers for health, social services, and postsecondary education and permit the provinces to raise an equivalent amount of tax revenue directly.

The Principles: Standard Objectives of Federal Fiscal Arrangements

The appropriate design of fiscal arrangements must begin with the issue of expenditure assignment. Bird (2003) argues that expenditure responsibility

should be assigned to the lowest level of government consistent with its efficient delivery.

The Assignment Problem and Transfers

So long as there are local variations in tastes, costs, local delivery will generate efficiency gains over uniform delivery of services by the central government — an idea that Oates (1972) labels the "decentralization theorem." Of course, the effects of many local services do not stop at the water's edge — or the provincial border. Local decisions in many key areas will inevitably have impacts felt throughout the nation, and this motivates some degree of central government involvement in a variety of areas. For example, Bird observes that in the education sector, central governments may appropriately set national standards for graduates and for teachers and even influence curriculum decisions, as a mechanism for ensuring smooth functioning of the national labour market.

Typically, however, the benefits of decentralization are held not to extend to the same degree for the revenue side of the government budget. The potential for tax competition among local governments, for tax exportation to local nonresidents, and a variety of other fiscal externalities reinforce the commonly held notion that in a federation revenue-raising authority should be more centralized than expenditure authority. The result is typically a vertical fiscal gap (VFG) between revenue and expenditure on own account at the central and local levels, which must be closed through transfers.

Transfers are how most countries achieve vertical fiscal balance, that is, ensure that the revenues and expenditures of each level of government are approximately equal. Vertical fiscal gaps may in principle be closed in other ways — by transferring revenue-raising power to local governments, by transferring responsibility for expenditures to the central government, or by reducing local expenditures or raising local revenues. In most countries, however, sufficient mismatch in the revenues and expenditures assigned to different levels of government remains for some balancing role to be assigned to intergovernmental fiscal transfers (Boadway and Hobson 1993).

Notwithstanding the Oatesian arguments for revenue centralization, some tax-setting powers will and should be decentralized to subnational governments. To the extent that is the case, revenues are apt to be distributed unequally between rich and poor regions — raising issues of fairness in the federal distribution of resources, and impeding the efficient functioning of the national labour market as well (Boadway and Flatters 1982). In such an environment, a horizontal equalizing transfer can play an essential role in federal fiscal arrangements. In the absence of equalizing transfers, governments would be unable to provide the public services at the tax rates that would otherwise

prevail in a centralized setting. Thus, equalization can be seen as an instrument for facilitating effective decentralization by enabling its benefits to be achieved while avoiding its adverse effects.[1]

Application of the horizontal balance principle is perennially controversial. In Canada in recent years, have-not provinces have been dismayed by the automatic decline in transfers under the Equalization program. The resulting calls for renegotiation have led to the 2004 New Framework agreement, the ongoing deliberations of the Expert Panel on equalization reform, and a number of bilateral agreements between Ottawa and receiving provinces. Thus, while few in Canada reject the principle of horizontal balance, its implementation is just as fluid and controversial today as is the vertical balance principle.

Getting the Incentives Right

The appropriate assignment of expenditure and revenue powers will inevitably lead to fiscal gaps — both vertically, between federal and provincial governments, to the extent that revenues are more centralized than expenditures, and horizontally, to the extent that needs and resources are unequally distributed among provinces. What is needed, therefore, is a transfer system to fill the gaps between revenues and expenditures at each level of government.

A simple approach to transfer design is simply to equalize actual revenues and actual expenditures of each government. Such "fiscal dentistry," as this approach has been called by Rao and Chelliah (1991), makes no sense. Equalizing actual outlays would discourage both local revenue-raising effort and local expenditure restraint, since under this system those with the highest expenditures and the lowest taxes get the largest transfers.[2]

This principle is recognized in Canada's fiscal arrangements, inasmuch as the major vertical transfers — the Canada Health Transfer and the Canada Social Transfer — are block (or lump-sum) funds, independent of provincial decisions,

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[1] Horizontal equalization transfers also serve an important insurance function for subnational governments — permitting governments to pool fiscal risks nationally and so to reduce the political and economic costs of short-run deficit finance (Boadway and Hayashi 2004; Smart 2004).

[2] As well, equalizing the actual outlays of local governments in per capita terms (raising all to the level of the richest local government) ignores differences in local preferences and hence one of the main rationales for decentralization in the first place. It also ignores local differences in needs, in costs, and in own revenue-raising capacity (Bird and Smart 2002).

and the horizontal Equalization program likewise bases transfers on measures of provincial revenue capacity that are independent of provincial tax policies. But, as I argue below, Canada's reliance on block funds appears paradoxically to be leading to an unstable situation, with poor incentives for actors at all levels of government.

In some limited circumstances, lump-sum grants may be inconsistent with getting the incentives right in a decentralized public sector, and federal matching grants will be required. The case for a matching component is usually made on one of two grounds. First, the prevalence of fiscal spillovers among governments in a federation means that matching may be required as a "Pigouvian" subsidy to efficient behaviour by governments. This is particularly true of expenditure programs that are locally administered but which have positive spillovers for residents of other jurisdictions in the country (Oates 1999), as, for example, with spending on roads and telecommunications, and possibly on public education. On the revenue side of the budget as well, local decisions to raise taxes create positive spillovers for nonresidents, to the extent that tax bases are mobile among jurisdictions of the federation. It is sometimes suggested (e.g., Wildasin 1991) that matching grants might be designed to internalize the resulting fiscal externality.[3] A more compelling case for matching grants in general can probably be made on the basis of informational and political considerations (Bucovetsky, Marchand, and Pestieau 1998).

The Practice: The Evolution of Federal Transfers in Canada

These principles suggest a simple algorithm for computing federal transfers: tax powers and expenditure responsibilities are assigned to the various levels of government, appropriate tax and spending levels are determined, and the required transfers are then computed as the difference between the two. This approach works poorly in the Canadian context, however, because the major tax bases are shared between Ottawa and the provinces. All provinces operate personal and corporate income tax systems that generate substantial revenues, using roughly the same base definitions as the corresponding federal taxes. Ottawa and all the provinces but Alberta tax consumption expenditures — although four provinces continue to use the inferior retail sales tax system in place of the value-added base adopted by Ottawa and the others (Dahlby 2005). Indeed, the only major tax bases not shared by both levels are the resource and property tax bases assigned exclusively to the provinces. The Canadian reality is

[3] Indeed, equalization programs like Canada's can serve this role, despite the absence of any explicit matching component in the grant formula. See Smart (1998) and Bucovetsky and Smart (2004).

therefore a long way from the canonical paternalistic federalism model, in which revenue collection is centralized, and transfers must finance the bulk of decentralized expenditures.

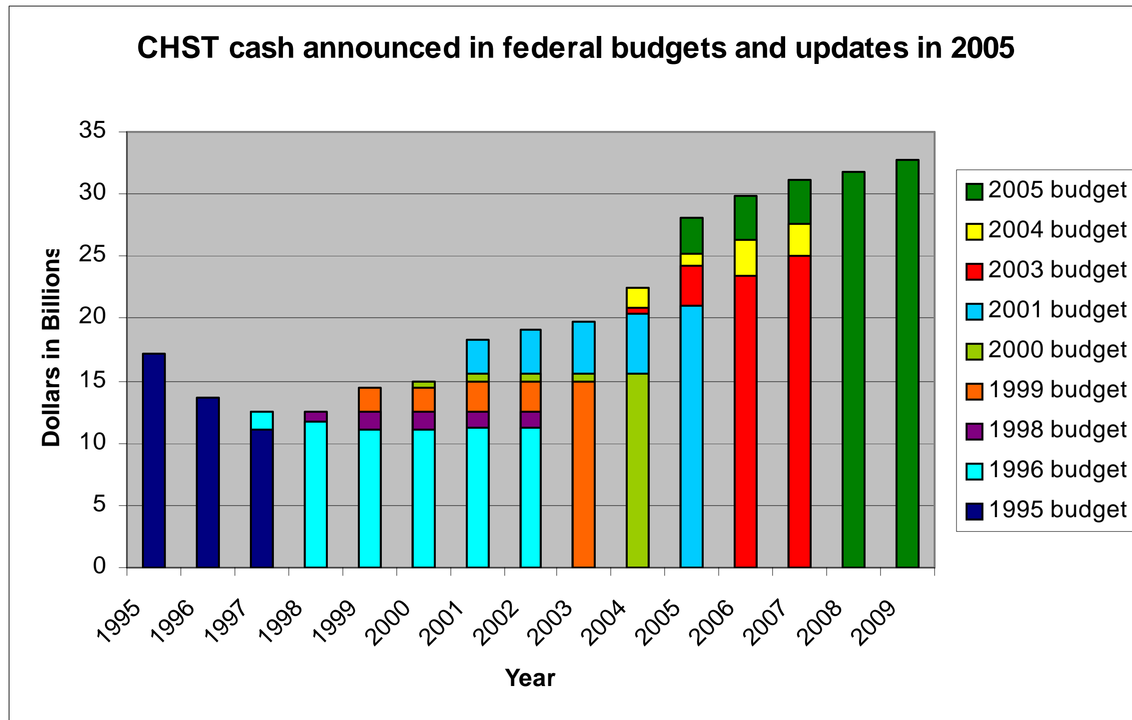
With shared tax bases, it is difficult on the basis of conventional public finance considerations alone to determine the appropriate level of intergovernmental transfers. Should federal personal income taxes rise to finance increased health-care expenditures, or should provincial income taxes? In the absence of important interprovincial spillovers in taxation or spending, as discussed above, the economic consequences of the two options are little different.

Of course, this simple fact has not prevented some commentators from arguing for a change in federal transfers and taxes — that is, for the existence of a vertical fiscal imbalance (VFI) in Canadian fiscal arrangements. One approach to measuring VFI, adopted by the Seguin Commission among others, is to compare federal and provincial spending and tax revenues, and they way in which they are projected to grow in the future (see also Bird and Tarasov 2004, for a related approach and international comparisons). Because provincial social programs will necessarily expand with the ageing of the population, this approach is usually quite propitious to the provinces' case. However, as others, including the federal Department of Finance, have pointed out, the approach is essentially meaningless: forecasts of future revenue growth are entirely dependent on assumptions about future tax effort. Since the federal and provincial governments have access to essentially the same tax bases, there is no apparent reason why provinces might not raise their own tax rates to finance increased spending, rather than relying on the federal government to do so.

So VFI is fundamentally a political concept, not an economic one: each level of government has its rhetoric on the issue, which receives very little credence from the other. Indeed, the evidence on the evolution of federal transfers in the last 10 years suggests that the federal government does not even believe its own rhetoric on the subject: transfers have increased substantially in response to provincial demands.

To show this, I report in Figure 1 the level of cash transfers under the Canada Health and Social Transfer (CHST, now separated into the eponymous CHT and CST programs) set in each federal budget since the 1995/96 fiscal year. The CHST has been the flagship federal-provincial transfer program since its inception in 1995, when it replaced a mix of specific-purpose block grants for health and postsecondary education under the Established Programs Financing (EPF) program and matching grants for social services under the Canada Assistance Plan (CAP).

Figure 1



The original objective of the CHST was to rein in federal spending commitments for provincial social programs — as evidenced by the decline in transfers up to 1997/98 — and arguably to sharpen incentives for the provinces to control spending increases, relative to the matching grants of cap. By 1997, however, the era of belt-tightening was over. Federal budgets since have repeatedly announced a plan for stable or even declining transfers under CHST over the medium term, only to have those commitments overturned and replaced by higher spending tracks in the next fiscal update or budget. In the face of higher-than-forecast surpluses, federal officials have faced exceptional pressure to increase transfers to the provinces, leading to the curious accounting device under which ongoing transfer increases have been "booked" against surpluses of previous years. Frequently, transfer increases have been the result of ultimatums by the premiers or deals negotiated directly among first ministers at their annual meetings — as was notably the case in 2000, 2003, and 2004.

The result is a transfer system very different in effect from that envisaged in 1995. Far from ensuring predictability of federal spending commitments, CHST cash transfers increased by nearly $17 billion in nominal terms between 1997 and 2004, to $28.1 billion from $11.1 billion. Far from sharpening incentives

for provincial governments through "hard budget constraints," it is federal transfers rather than provincial own source revenues that have financed the majority of incremental provincial health care expenditures: over the same period, provincial government spending on health care rose by $28.8 billion in nominal terms — thus 58.9 percent was effectively financed by federal transfers and only 41.1 percent by provincial taxes.

In effect, then, Ottawa has been unofficially operating a matching grant for health care much like the dollar-for-dollar matching grant that existed officially before 1977.[4] In the present environment, it is provincial spending that is pushing federal transfers higher, rather than the reverse, but the effect on the federal budget and on provincial incentives is arguably the same as if a formal matching grant were in place.

I stress that the point is not that provincial health-care spending has grown too fast in recent years, nor that the federal contribution to that spending should have been lower than it was. Rather, the more fundamental issue at stake is the way that governments' incentives are being distorted by our current system of complex and shifting fiscal arrangements.

The Case for Commitment

How are government incentives being distorted by current fiscal arrangements? Experience from other countries around the world suggests that Canadians should be concerned about a number of problems that can arise when fiscal arrangements are continually subject to renegotiation. Specifically:

- The bailout problem. When the federal government does not or cannot commit to transfers, there is a natural tendency to adjust them to favour subnational governments facing difficult fiscal circumstances — and so to bail them out of their troubles. While such responsive transfers provide a form of insurance to residents of the affected region, they naturally create a moral-hazard problem as well. Specific deficit bailouts and general federal transfers both soften the local governments' budget constraint and lead to inefficient resource allocation (Inman 2001). Thus, for example, many observers (notably Saiegh and

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[4] CHST transfers have in principle been linked to provincial expenditures on postsecondary education and social services, as well as to health care, so that the effective matching rate for all assisted expenditures is somewhat lower than reported here. But education and social service expenditures have grown little compared to health, and provincial demands for federal transfers have been based on health-care costs rather than the other expenditure components. It therefore seems appropriate to include only health-care expenditures in the denominator of the calculated effective matching rate.

Tommasi 1999) attribute the Argentine fiscal crisis of 1999 in large measure to its unstable system of revenue sharing between federal and provincial governments during the 1980s and 1990s, and the perverse incentives it created for subnational government spending and borrowing decisions. Likewise Treisman (1997) argues that federal grants have been much influenced by partisan political considerations, which has stood in the way of implementing key tax policy reforms at the local level, in turn blocking economic development (Zhuravskaya 2000).

In Canada, the issue is not subnational debt — most of the provinces are in that respect acting quite conservatively. Here the problem is more subtle, relating to the provinces' substantial but implicit liabilities for health care and other social services. Most observers argue that the ageing of the Canadian population has raised implicit provincial liabilities for health care to unsustainable levels, necessitating some kind of fundamental reform to the system. But provinces have little incentive today to set their own fiscal houses in order, since spending restraint must weaken the case for future increases in federal transfers. Arguably, provincial governments may even be induced to manufacture "crises" in health care to get federal attention to the issue.

- The common-pool problem. Of course, federal bailouts of provincial spending tracks inevitably come at the expense of federal taxpayers — who are provincial taxpayers and voters as well. Shouldn't this eliminate incentives for the provinces to attempt to finance provincial spending with federal revenues? Not in the current environment, given the extent to which federal transfers are borne by taxpayers in Ontario and Alberta, and the evidence that each province may obtain its own deal from Ottawa through bilateral negotiation. Given this, federal tax revenues are a common pool of resources that is available to whomever is the first to exploit them. Like all poorly managed common property resources, this leads to an inevitable tendency to overexploitation. In this perspective, we are witnessing a race among provincial governments to exploit taxpayers in other provinces through federal transfer negotiations.

- The fiscal illusion problem. The common-pool problem cannot, however, explain the observed tendency even for the have provinces to push for greater per capita federal transfers, since the only reasonable expectation is that equal per capita transfers will be financed disproportionately by taxpayers in Ontario and Alberta (Ontario Chamber of Commerce 2005). Current transfer arrangements, then, create a further problem of fiscal illusion on the part of voters and their elected leaders. When the premiers call for more federal transfers, they pretend this could be done without increasing the federal tax and debt burden on their own citizens. Naturally, the premiers would like to

spend more without raising taxes themselves. It is only the current system of murky shared responsibility that makes this seem like more than a pipe dream.

An interesting and novel perspective on this debate is offered in the theoretical analysis of Boadway and Tremblay (2005). They examine an environment in which federal and provincial governments share a common tax base (as in Canada), and federal transfers are needed to equalize the costs of raising revenue among provinces. Because a shared tax base tends to lead to tax rates that are too high from a national perspective, in their model the best fiscal arrangement would be to have very low federal taxes — to offset the high level of provincial taxes — and so very low federal transfers most of the time. But, they show, if the federal government cannot credibly commit to tax and transfer levels, the result is provincial taxes that are too low, as provinces compete for transfers, and federal taxes and transfers that are too high in consequence — arguably, exactly what we do see today.

In a sense, the Boadway and Tremblay equilibrium is optimal, in that without a mechanism for fixing its transfer policies, the federal government could do no better than to accept the resulting high level of taxation and unnecessary transfers. But this depends crucially on what one believes about the power of the federal government to commit to tax policies for the future. In theory, if the federal government could find a device that made the promise of low future transfers credible, then provinces would be induced to raise their own taxes and to lower spending, making residents of all provinces better off.

The Case for Tax Point Transfers

The previous section describes the dangers inherent in what Mintz and I (2002) have called Canada's co-dependent constitutional relations: with our current fiscal arrangements, Ottawa raises the money, and the provinces spend it. The result of this fiscal churning is that no government has clear responsibility for delivering key programs, and both sides blame the other when something goes wrong.

But what is the alternative? One proposal, advanced in 2002 by the Seguin Commission in Quebec and also advocated by a number of the premiers, is for a so-called tax point transfer from Ottawa to the provinces. Under the proposal, federal cash payments under the CHT and CST would be eliminated entirely, in exchange for a transfer of federal tax revenues to the provinces. At current levels of funding, Ottawa would have to cede about 4.5 percentage points of income tax, or about the same number of points from the federal GST tax base to make the proposal deficit neutral at both levels of government.

A tax point transfer would put an end to the continued renegotiation of federal transfers and the resulting fiscal illusion for voters. If the provinces wished to spend more on health care they would have to increase taxes directly, and face the wrath of voters on election day if their decisions were the wrong ones. The change might increase voter satisfaction with the federal government as well. No longer would federal tax payments seem to disappear into thin air.

If the proposal is such a good idea, why is the federal government so emphatically opposed? Ottawa has long seen itself as the guardian of pan-Canadian standards in health care, and cash transfers are the carrot and stick believed to keep the provinces in line. Perhaps, but it may be time to trust provincial governments to give their citizens the health-care systems they want. National standards could be stifling needed reforms in the health-care system, and they have little economic rationale, since health-care policies do not create spillover effects for other provinces. This is in contrast to education policies, which affect the quality of our mobile labour force.

A greater stumbling block may be regional inequality. A tax point transfer would be worth far more to the rich provinces than the poor ones. In the past, the federal government has dealt with this by paying Equalization to the have not provinces and reducing cash payments to Ontario and Alberta to ensure the transfers had equal value for all. But if cash payments were eliminated altogether, there would be no easy way to claw back the extra funds, and Ottawa would lose billions to the rich provinces. Nevertheless, we could require Ontario and Alberta to pay into the Equalization system if they want to take back the federal tax points. Such an arrangement would leave these provinces no worse off in the short run.

But the precise details of implementation of a tax point transfer are for the first ministers to decide. However it is done, a tax point transfer could benefit all of us. It would let us see clearly where our tax money is going and decide how it should be spent.

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